

Office of Chief Counsel
Internal Revenue Service
Memorandum

Number: 200714017

Release Date: 4/6/2007

CC:CORP:B04:
POSTF-119260-06

UILC: 108.02-00, 1502.00-00

date: December 01, 2006

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subject: Consolidated Attribute Reduction

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ISSUE

Whether, for periods prior to the adoption of Treas. Reg. § 1.1502-28T, under section 108(b) of the Internal Revenue Code and the consolidated return regulations, members of a consolidated group with excluded _____ must reduce net operating losses, alternative minimum tax credits, and asset basis on a single or separate entity basis.

CONCLUSION

For periods prior to the adoption of Treas. Reg. § 1.1502-28T, section 108(b) and the consolidated return regulations require members of a consolidated group with excluded _____ to reduce net operating losses and alternative minimum tax credits on a single entity basis and to reduce asset basis on a separate entity basis.

LAW AND ANALYSIS

Section 61(a)(12) generally requires taxpayers to include in gross income any income from cancellation of indebtedness. Section 108(a)(1)(A) permits a taxpayer to exclude from gross income if the discharge of indebtedness occurs in a title 11 (bankruptcy) proceeding. Section 108(b)(1) generally requires taxpayers to reduce their attributes by the amount of excluded from gross income under section 108(a) ("excluded"). Section 108(b)(2) provides the order in which taxpayers with excluded must reduce their attributes.

Section 108(b)(2)(A) requires taxpayers to first apply excluded to reduce their net operating losses ("NOLs"). A member of a consolidated group with must reduce the group's because, with regard to consolidated return years, no member possesses a separate NOL to reduce. This principle flows directly from the rationale of the Supreme Court in United Dominion Industries, Inc. v. United States, 532 U.S. 822 (2001). In United Dominion, the Court had to determine whether a member of a consolidated group had a separate NOL or only a for purposes of determining whether a product liability loss ("PLL") for members of a consolidated group should be determined by reference to the NOL of each member or to that of the entire group. See id. at 829 ("The first step in applying the definition and methodology of PLL to a taxpayer filing a consolidated return thus requires the calculation of NOL."). In holding for the taxpayer, the Court determined that, with regard to consolidated return years, a separate NOL of a member of a group "simply does not exist." Id. The Court's conclusion that a separate NOL does not exist means that a member of a consolidated group with excluded must reduce its under section 108(b)(2)(A) because no other alternative exists.

The Court in United Dominion addressed additional arguments that this taxpayer may raise in arguing that it can reduce NOLs on a separate member basis. The taxpayer could attempt to use the definition of separate NOL provided in § 1.1502-21(b)(2)(iv) (2002). In response to a similar argument made by the taxpayer in United Dominion concerning § 1.1502-79(a)(3) (1996), the predecessor to § 1.1502-21(b)(2)(iv), the Supreme Court stated "[s]ection 1.1502-79(a)(3) unbakes the cake for only one reason, and that reason has no application here. The definition... applies, by its terms, only 'for purposes of' § 1.1502-79(a)(3), and context makes clear that the purpose is to provide a way to allocate CNOL to an affiliate member that seeks to carry back a loss to a 'separate return year.'" Even though § 1.1502-21(b)(2)(iv) did not apply to the taxable year at issue in United Dominion, the Court noted that the section's reference to a separate NOL stems more from "careless drafting than meaningful design." United Dominion, 532 U.S. at 831 n. 7 (citation omitted). Accordingly, because the consolidated return regulations in effect at the time of the taxpayer's discharge of indebtedness provided no means for calculating a separate NOL for purposes of attribute reduction under section 108, the only NOL that the taxpayer could reduce is its CNOL.

Alternatively, the taxpayer may argue that it may calculate separate NOLs for each member of the consolidated group based on the rules provided for calculating separate taxable income ("STI") under § 1.1502-12. However, a group member's calculation of STI using these rules would produce a different result than that obtained by a corporation filing a separate return because, in calculating STI, § 1.1502-12 excludes capital gains and losses and several other items ordinarily included in a separate corporation's income. See United Dominion, 532 U.S. at 832. As a result, such a calculation cannot be used to determine a group member's separate NOL for purposes of attribute reduction under section 108.

Further, the legislative history of section 108 makes clear that attributes of the group of a debtor member are reduced in furtherance of the goal of deferring, rather than permanently excluding, CODI from gross income. See H.R. Rep. No. 96-33 at 9 (1980); S. Rep. No. 96-1035 at 10 (1980). In order to minimize the permanent exclusion of CODI from gross income, a debtor member of a consolidated group must reduce all attributes that would ordinarily be available to offset its income as a member of the group. CODI, like any other income incurred by a member of a group, must offset the group's CNOL.

The rationale of United Dominion and the legislative history of section 108 also require that alternative minimum tax ("AMT") credits be reduced on a single entity basis. The court in United Dominion held that § 1.1502-79(a)(3) (1996) and § 1.1502-21(b)(2)(iv) (2002), which provide special rules for apportioning NOLs to separate return years ("SRYs"), do not provide a means of calculating separate NOLs for any purpose other than calculating SRY carryovers. Likewise, section 1.1502-55(h)(4) provides rules for apportioning AMT credits to SRY years and not calculating separate member AMT credits for any other purpose.

Basis in property is the only attribute listed in section 108(b)(2) that is not a consolidated attribute. As a result, CODI of a particular debtor member may only be used to reduce the basis of property of the debtor member.

This taxpayer argues that section 108(b) reduces the attributes of the "taxpayer" with CODI but does not state whether, as applied to debtor members of a consolidated group, "taxpayer" means the debtor member or the entire consolidated group. This question is meaningless, however, since, with the exception of asset basis, all attributes of a debtor member of a consolidated group exist only on a consolidated basis. Therefore, those assets must be reduced on a consolidated basis.

The taxpayer further argues that, in the absence of any specific regulations addressing whether a debtor member must reduce attributes, any reasonable approach must be allowed. Gottesman & Co. v. Commissioner, 77 T.C. 1149 (1981). In this case, the taxpayer seeks to adopt a position that is inconsistent with the purpose of Code section 108 and the Supreme Court's decision in United Dominion. Therefore, the taxpayer's approach is not reasonable, and Gottesman is inapposite.

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